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CHARLES ELMORE CROP

IN THE

Supreme Court of the United States

OCTOBER TERM 1949.

No. 775

GENERAL STEEL CASTINGS CORPORATION, *et al.*,
Petitioners,

v.

JOHN S. KROESE.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT.

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT.

General Steel Castings Corporation, Charles E. Acker and John D. Tyson pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Third Circuit entered in the above-entitled case on January 31, 1950, reversing the judgment of the District Court of the United States for the Eastern District of Pennsylvania (Judge Ganey).

Opinions Below.

The opinion of the United States District Court for the Eastern District of Pennsylvania is reported at 9 F. R. D. 273 and appears in the Record at pages 11-14. The opinion of the United States Court of Appeals for the Third Circuit is reported at 179 F. 2d 760 and appears in the Record at pages 19-27.

Jurisdiction.

The judgment of the Court of Appeals was entered on January 31, 1950 (R. 28). The jurisdiction of this Court is invoked under 28 U. S. C. §1254.

Questions Presented.

The principal question presented is whether the directors of a corporation, or at least a quorum thereof, are indispensable parties defendant to a suit by a stockholder to compel the payment of a dividend. A further question, which may require resolution in the first instance, is whether, in actions brought in the federal courts on the basis of diversity of citizenship, the indispensability of a party is to be determined by state rather than federal rules and decisions.

Statement.

In this suit by a stockholder to compel the payment of a dividend, the petitioners, before answering, moved to dismiss the amended and supplemental complaint on the ground that at least a majority of the directors were indispensable parties defendant but had not been joined. The District Court granted the motion, but was reversed by the United States Court of Appeals, which remanded the case for trial on the merits.

From the complaint and the motion papers the following facts appear:

General Steel Castings Corporation, a Delaware corporation, owns and operates steel castings plants in Pennsylvania and Illinois (R. 3). It has outstanding 100,000 shares of preferred stock, on which dividends are cumulative at

the annual rate of $6 per share, and 456,576 shares of common stock (R. 3). The certificate of incorporation provides that dividends shall be payable "when and as declared by the Board of Directors"; that no dividends may be paid on the common stock until all preferred dividends, both current and accrued, have been paid; and that if four quarterly preferred dividends are in arrears, the preferred stockholders are entitled to elect one-third of the board of directors (R. 14, 15).

From 1932 through the first three quarters of 1941 no dividends were paid and arrears of $60 per share accumulated on the preferred stock (R. 4). In the last quarter of 1941 dividend payments on the preferred stock were resumed and since that time the full regular dividend of $6 per share (totalling $600,000) has been paid each year (R. 4). In 1948, in addition to the current payments, reduction of the accumulated arrears was initiated and prior to the filing of the complaint three extra quartely dividends of $.75 per share each had been paid on account of the arrears (R. 5).

In his complaint, the respondent demands immediate payment of the entire unpaid balance of the arrears in the alleged amount of $57.75 per share, or a total of $5,850,000 [*sic*] (R. 10). This demand is based on allegations showing that the corporation had net earnings averaging $2,280,000 per year from 1940 to 1947 and that funds which might have been used to pay off the preferred dividend arrears more rapidly have been used for other corporate purposes, namely, setting up a reserve for contingencies ($1,200,000), increasing the reserve for plant and equipment ($8,900,000), reducing the corporation's funded debt (by $3,500,000), and making additions to surplus account which, as of December 31, 1947, showed a total capital surplus of $4,100,000 and a total earned surplus of $13,400,000 (R. 5, 6). The

respondent asserts that since the corporation had, as of December 31, 1947, a net worth of $28 million and net current assets of $12 million, it "is fully able to pay the accumulated dividend arrears" (R. 9).

The complaint contains no allegation that any dividends have ever been paid on the common stock or that any corporate funds have been misappropriated by the directors. It reveals that the corporation still had outstanding, as of December 31, 1947, $3 million of funded debt, bearing interest at 3% per annum, and maturing at the rate of $600,000 each year (R. 6), and that, when the complaint was filed, the corporation had been paying the current dividend on the preferred amounting to another $600,000 per year regularly for more than six years (R. 4) and had started payments on the preferred arrears at the rate of $300,000 per year (R. 5). The complaint alleges, however, that the actions and decisions of the directors in failing to pay off the entire arrears, have been primarily in the interest of the four principal common stockholders of the corporation, American Steel Foundries, The Baldwin Locomotive Works, the American Locomotive Company and Pullman Incorporated, who between them own over 92% of the outstanding common stock (R. 9). The complaint concludes with the charge that the "acts and decisions of General Steel and its Directors have not been in good faith, but have been in violation of their duties as fiduciaries to the holders of said preferred stock" (R. 9).

* * *

The original complaint named General Steel Castings Corporation as the sole defendant, and alleged "diversity of citizenship" as the basis for federal court jurisdiction. Upon a motion to dismiss that complaint, on the ground that at least a quorum of the board of directors were indis-

pensable parties defendant, the District Court (Henderson, J.) entered an order (without prejudice to a later renewal of the objection), directing that at least a majority of the directors of the corporation be made parties defendant and that the summons and complaint be served upon the directors, as provided by law (R. 1).

Respondent thereupon filed an amended and supplemental complaint which was identical in all material respects with the original complaint, but added the names of nine of the corporation's twelve directors as defendants (R. 3). The amended and supplemental complaint contained no allegation as to the citizenship of the individual parties but alleged that the plaintiff is a resident of New York, and that three of the directors are residents of Pennsylvania, four of them are residents of Illinois, and two of them are residents of Missouri (R. 3, 8). Only the three directors alleged to be residents of Pennsylvania were served and one of them has since died (R. 18).

The corporation renewed the motion to dismiss on the ground that the absence of indispensable parties had not been cured (R. 10). The three directors who had been served filed similar motions. On June 30, 1949, the District Court (Ganey, J.) held that a majority of the board of directors of the corporation were indispensable parties to this action, and dismissed the complaint without prejudice to the plaintiff or any member of the class for the benefit of whom this action had been instituted (R. 2).

The plaintiff appealed from the judgment of the District Court to the Court of Appeals for the Third Circuit. On January 31, 1950, the Court of Appeals for the Third Circuit reversed the order of dismissal and remanded the case for further proceedings not inconsistent with its opinion (R. 28).

Specification of Errors to be Urged.

The Court of Appeals erred:

1. In reversing the judgment of the District Court.

2. In holding that the indispensability of a party is to be determined in federal courts by state rather than federal rules and decisions.

3. In holding, in the alternative, that under federal rules and decisions a majority of the directors are not indispensable parties defendant in an action to compel the payment of a dividend.

4. In holding that under the law of Pennsylvania a majority of the directors are not indispensable parties defendant in an action to compel the payment of a dividend.

Reasons for Granting the Writ.

In this case a stockholder, dissatisfied with the rate of payment of preferred stock dividend arrears, sues to compel the immediate payment of the entire balance. The complaint charges that in not authorizing more rapid payment of the arrears, the directors have acted "in violation of their duties as fiduciaries" (R. 9). Stockholders' suits for dividends, charging misconduct by the directors, are not uncommon in our courts. But for the first time it is held that the directors are not indispensable parties defendant to such a suit. The court below says that notwithstanding their absence, the complaining stockholder is entitled to a ruling on his charges of fiduciary misconduct and, if they are sustained, to a decree directing the corporation to pay the dividends.

In reaching this novel result, the court has acted in disregard of all former precedent, both federal and state. The court declares that state rather than federal rules and decisions control the question whether the directors are indispensable parties, but that the same result "can be reached by either route" (R. 20 n. 1). While this leaves the *ratio decidendi* in doubt, we submit that either route leads to a conflict with one or more decisions of other United States Courts of Appeals. As a holding that state rather than federal rules and decisions determine the question of indispensability, the decision is in conflict with cases in the Fifth, Seventh and Ninth Circuits mentioned below. As a holding that under federal rules and decisions the directors are not indispensable parties, the decision conflicts with a Sixth Circuit case mentioned below. In addition, we deny that the court below has correctly ascertained the Pennsylvania law as to indispensability of parties, which at one place in its opinion the court purports to follow. In the end the court seems to point with pride to its disregard for precedent: "There must always be a first time for every legal rule. That is the way the law grows" (R. 26-27).

No court, however, can reject as antiquated or obsolete the plain truth that "the ordinary suit to have dividends declared is against the directors themselves for misconduct." *NY PA NJ Utilities Co.* v. *Public Service Commission of New York,* 23 F. Supp. 313, 314 (S. D. N. Y. 1938). That is the primary reason why until now the courts have declined to take jurisdiction of such cases unless the directors responsible for the policies under attack were before the court. In this case the presence of the corporation itself and jurisdiction over its property are held to be sufficient, since the court then has "power", if "wielded . . . with legal imagination" (R. 25), to force dividend action without a decree *in personam* against the directors. But even if the

exercise of such power would be consistent with the Delaware corporation law (which we deny), the court must first decide whether or not the directors have been unfaithful fiduciaries. Until the decision below, the rule has been that this primary issue could be determined only by a court which had the directors before it, so that they could be heard in their own defense and so that they would be bound by the judgment. Usually there has been one, and seldom more than one, court having such jurisdiction.

Moved by the complaining stockholder's assertion that in this case "there is no one state or federal district in which a majority of the board may be served" (R. 8), the court below has laid down a rule which if generally adopted would open the door to suits by stockholders attacking the dividend policy of the directors in the state and federal courts of every jurisdiction in which a corporation is found. Conflicting decisions would be inevitable where so much depends on the delicate balancing of business judgments. Which of the many courts having co-ordinate jurisdiction would have the final say? How would directors be aware of their obligations, and more important still, how would stockholders know their rights, under such conditions?

In view of the conflicting decisions in other circuits and the public interest in obtaining a clear definition of corporate and fiduciary rights and duties, the decision below merits review by this court.

• • •

The fact that the judgment of the court below is interlocutory is no bar to review by this court. *Gay* v. *Ruff*, 292 U. S. 25 (1933). "In diversity cases, the question of indispensable parties is inherent in the issue of federal jurisdiction. . . . Jurisdictional questions come first in the

orderly disposition of a case." *Calcote* v. *Texas Pac. Coal & Oil Co.*, 157 F. 2d 216, 218 (C. A. 5, 1946), cert. denied 329 U. S. 782 (1946).

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1. As a holding that state rather than federal rules and decisions determine the question of indispensability, the decision below is in conflict with the decisions of other United States Courts of Appeals.

In *Lawrence* v. *Sun Oil Co.*, 166 F. 2d 466 (1948), the Court of Appeals for the Fifth Circuit, after stating the general rule that procedure in the federal courts is governed by the federal rules and not by state law, observed (p. 469): "This is particularly true in diversity cases where the question of indispensability of absent parties arises." To the same effect is the decision of the Seventh Circuit in *De Korwin* v. *First National Bank of Chicago*, 156 F. 2d 858, cert. denied 329 U. S. 795 (1946) and of the Ninth Circuit in *Chicago, M. St. P. & P. R. Co.* v. *Adams County*, 72 F. 2d 816 (1934).

The court below says that this rule, as restated in *Moore's Federal Practice* (2d Ed. 1948) Vol. 3, par. 19.07, "... cannot apply where the question of the indispensability of a party depends upon substantive law which in the diversity case is a matter of the law of the state" (R. 20 n.1). It may be true that, for example, when the question of indispensability can be answered by determining whether a particular property right is joint or several, or whether a particular interest is contingent or vested, the substantive law of the state decides the matter. But this is not that sort of case. The rule of substantive law here involved is that directors must exercise an honest business judgment in declaring dividends. This does not decide the matter of whether the directors are indispensable parties to a suit brought to de-

termine whether an honest judgment has been exercised. The court below refers (R. 20 n. 1) to *Ohlinger's Federal Practice* (1948), Vol. 3, "for what seems to us a more accurate analysis of the situation" (than Moore's), but Ohlinger says, page 357, "As pointed out above, the character of the right or interest is a matter of substantive law; on the other hand, the question whether parties are indispensable in the sense that the court cannot do justice to the parties before it without injuring the rights of absent persons is one of procedure, governed by federal rules." That is the sense in which the question arises here.

To let state law determine the question of indispensability in a case like this would mean that the federal court could not always decide for itself whether diversity exists. Suppose the issue relates to the indispensability of a person who is a citizen of the same state as the plaintiff, and that under the state law he is an indispensable party defendant but under federal rules he is not. Federal diversity jurisdiction would be curtailed by applying the local law. *Erie R. Co.* v. *Tompkins* does not deprive the federal courts of the right to determine for themselves this type of indispensability question, on which their jurisdiction may turn. "To hold otherwise would lead to the illogical conclusion that the jurisdiction of federal courts not only may be limited, but abrogated by the edict of the state Legislature or decision of the Supreme Court of the state in which the federal court sits." *Stephenson* v. *Grand Trunk Western R. Co.*, 110 F. 2d 401, 405 (C. A. 7, 1940).

2. As a holding that under federal rules and decisions the directors are not indispensable parties, the decision below is in conflict with the decision of the United States Court of Appeals for the Sixth Circuit in *Schuckman* v. *Rubenstein*, 164 F. 2d 952 (1948), cert. denied 333 U. S. 875.

The court below admits that the *Schuckman* case is "...squarely against the conclusion here reached". (R. 26) It seeks to soften the impact of the conflict by stating that "While the court in that case does not say anything about it, we take it that it must have been giving its views on Ohio law". (R. 26) This is merely reading into the other opinion the ideas of the court below. If the Sixth Circuit Court had been applying state law it would have said so, as the court below has done, and in its discussion of indispensability it would not have made such extensive citation of decisions of this Court and lower federal courts as well as the federal Judicial Code. Conflict of the decision below with the *Schuckman* case cannot be avoided on any such plea. The two cases, diametrically opposed not only in their results but in their reasoning and underlying philosophy, have excited wide interest. It has been generally conceded that they present irreconcilable views on an important question of law relating to corporations and fiduciaries which this Court alone can settle.

3. As a holding that under the law of Pennsylvania the directors are not indispensable parties, the decision below is erroneous and out of harmony with the rulings of the Pennsylvania courts.

This may be explained, in part, by the court's statement that "Pennsylvania law was not briefed by either party in the argument" (R. 20). The respondent evidently saw nothing to be gained in so doing since he never argued for application of the local law. The petitioners believed and still maintain that federal rules and decisions are controlling. In any event, while it is true as the court said that there is no Pennsylvania decision "directly in point", we cannot agree with the further statement that there is none "anywhere near it" (R. 20). Is it of no signifi-

cance that in each of the cases cited by the court below (R. 23) where Pennsylvania courts have intervened to give redress for fiduciary misconduct, the directors were named as defendants? Or that in the leading Pennsylvania cases where stockholders have sued to compel the payment of dividends, the directors have been joined as defendants, and the courts have adopted the usual view that such actions are essentially directed against the board of directors for a breach of trust? *Jones* v. *Motor Sales Co.*, 322 Pa. 492, 185 Atl. 809 (1936); *McLean* v. *Pittsburgh Plate Glass Co.*, 159 Pa. 112, 28 Atl. 211 (1893).

In *Green* v. *Philadelphia Inquirer Company, et al.*, 329 Pa. 169, 196 Atl. 32 (1938), the court stated (p. 174) that the remedy of a stockholder who is dissatisfied with dividend policies is ". . . a suit against the company and its directors. To be successful in such a suit an abuse of discretion on the part of the directors would have to be shown."

In addition to these Pennsylvania state court decisions, the court below, without citing contrary authority, has failed to consider other reliable precedents to which a Pennsylvania court would look in approaching this same question *de novo*. These include *Isaac* v. *Milton Manufacturing Co.*, 33 F. Supp. 732 (1940) where in dismissing the complaint because of failure to join the directors as defendants, the United States District Court for the Middle District of Pennsylvania said (p. 737) ". . . all the acts of misconduct and mismanagement alleged in the complaint are wrongs charged to have been committed by the directors of the corporation, and yet not one director has been made a party defendant in the action." See also *Rhoads* v. *National Iron Bank of Pottstown, Pa.*, 35 F. Supp. 650 (E. D. Pa. 1940).

A Pennsylvania court would also rely upon the well-reasoned opinions of courts in other jurisdictions and the statements of leading text-writers such as the following, all of which support our position: *Schuckman* v. *Rubenstein, supra; Gesell* v. *Tomahawk Land Co.*, 184 Wis. 537, 200 N. W. 550 (1924); *Connelly* v. *Weisfeld, et al.*, 142 N. J. Eq. 406, 59 A. 2d 869 (1948); *Kales* v. *Woodworth*, 32 F. 2d 37 (C. A. 6, 1929), cert. denied 280 U. S. 570 (1929); *Moore's Federal Practice* (2nd Ed. 1948), Vol. 3, Sec. 19.14; *Ohlinger's Federal Practice* (1948), Vol. 3, page 357.

In the *Gesell* case, *supra*, the court clearly summarized the theory underlying the general rule that the directors must be joined as defendants in such actions as follows (p. 555): "In view, therefore, of the situation in which the directors of a corporation are placed by statute and decisions both as to the corporation itself and as to stockholders or others interested and their individual liability for any violation of the statute controlling the payment of dividends, we are of the opinion that in an action brought to compel the payment of a dividend, it appearing that the directors have not acted or have refused to act in that regard, the directors themselves are necessary parties and entitled to be heard."

The failure of the court below to refer to the foregoing authorities is contrary to the admonitions of this Court and ignores the recognized responsibility of federal courts in ascertaining and applying the state law. *Meredith* v. *Winter Haven*, 320 U. S. 228 (1943); *Burns Mortgage Co.* v. *Fried*, 292 U. S. 487 (1934); *Crab Orchard Imp. Co.* v. *Chesapeake & O. Ry. Co.*, 115 F. 2d 277 (C. A. 4, 1940), cert. denied 312 U. S. 702.

Conclusion.

For the reasons stated, it is respectfully submitted that this petition should be granted.

Respectfully submitted,

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